WORLDCOM

October 23, 2002

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: EX PARTE , CC Docket No. 01-338 (Triennial Review of UNEs); CC Docket No. 96-98 (Local Competition); CC Docket No. 98-147 (Advanced Services); CC Docket Nos. 00-218, 00-249, and 00-251 (Virginia Arbitration)

Dear Ms. Dortch:

In its September 9 ex parte in the above captioned dockets,[1] SBC asks the Commission to use the Virginia Arbitration as a vehicle to provide guidance to the states on the application of total element long run incremental cost (TELRIC). Similarly, in a July 18 ex parte,[2] Verizon requested the Commission provide greater guidance on TELRIC "in any arbitration" that may come before the Commission – which can only be a reference to the Virginia Arbitration. Both of these carriers urge the Commission to establish specific input values that are critical determinants of TELRIC rates. Each of these input questions was the subject of substantial dispute in the Virginia Arbitration, provoking extensive comments before the Wireline Competition Bureau by WorldCom, AT&T and Verizon.

The Wireline Competition Bureau should decide the arbitration based on the vast evidence before it, not based on late-filed ex partes that merely repeat points decisively refuted in the arbitration itself. SBC is not even a party to the Virginia proceeding. And Verizon had every opportunity to make its case on all the points discussed in its letter in the thousands of pages of written materials submitted to the Bureau and during several weeks of hearings. But apparently fearing what the evidence shows, SBC and Verizon attempt essentially to reopen the record outside of the adjudicatory process altogether. The Bureau should disregard this belated effort.

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[1] Letter from Jim Lamoureux, SBC to Marlene H. Dortch, FCC CC Docket No. 01-3138, dated September 9, 2002.

[2] Letter from W. Scott Randolph, Verizon to Marlene H. Dortch, FCC, CC Docket No. 01-338, dated July 18, 2002.

In reality, the SBC/Verizon letters are part of a Bell Operating Company (BOC) onslaught against current unbundled network element (UNE) prices, and against the continued existence of UNE-P, based on their assertion that they are not making a sufficient profit on wholesale customers. But the BOCs have already lost the theoretical argument as to whether TELRIC allows them a reasonable profit. WorldCom has previously explained why TELRIC is the economically correct method to use to set UNE-P prices and that TELRIC enables efficient BOCs to make a reasonable profit, albeit a profit that may be lower than the monopoly profits the BOCs previously had obtained.[3] Indeed, the Commission has previously concluded that TELRIC provides for "a reasonable profit and thus no additional profit is justified under the statutory language."[4] And the Supreme Court has agreed.[5]

Having lost the argument that TELRIC is illegal, the BOCs now argue that as a practical matter the states have misapplied TELRIC and set UNE rates too low. But this argument also fails. The BOCs' suggestion that the states are uniformly setting unrealistically low rates because they have all made identical "errors" in setting TELRIC inputs is demonstrably false. Indeed, the most common state "errors" favor the BOCs. Although many states have now reduced UNE rates from the sky-high level at which they were initially set, this is only after years of litigation. And even the new rates almost uniformly remain above true TELRIC rates. In many states, the rates are too high because the states have accepted cost models that are infected with embedded costs. The evidence in the Arbitration shows that lower rates are appropriate.

WorldCom agrees with the BOCs that states will surely look to the result of the Virginia Arbitration for guidance in setting TELRIC rates. But that is all the more reason for the Bureau to decide the Arbitration based on the extensive evidence before it, rather than on the political considerations that underlie the BOC rhetoric. Those political considerations also do not justify treating the Arbitration as a rulemaking in which to rewrite TELRIC rules in the name of "clarification." The Virginia Arbitration is being decided by the Wireline Competition Bureau acting in the stead of the Virginia Commission. Pursuant to delegated authority from this Commission, the Bureau's task is to apply existing FCC rules, not to rewrite those rules.[6] Nor should the Commission rewrite the rules in any other proceeding pending before it. The Commission has not received extensive comment on TELRIC inputs in any proceeding other than the Virginia Arbitration. Further, for some inputs a general rule would not be warranted. Some inputs depend on

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[3] See Reply Comments of WorldCom, Inc., CC Docket Nos. 01-338, 96-98, and 98-147, July 17, 2002, at page 55-62.

[4] See In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 F.C.C.R. 15499, ¶ 699 (1996) ("Local Competition Order").

[5] See Verizon Communications, Inc. v. FCC, 2002 WL 970643, *19 n. 19 (2002).

[6] See 47 C.F.R. § 51.505(e)(1) (state commissions required to follow FCC rules in arbitrating disputes over interconnection agreements).

specific circumstances in individual states and a uniform rule would not allow the necessary flexibility for states to account for such circumstances. Given the ILECs' long-held claims that the FCC has assumed too much authority in setting rates, and that its local competition rules are too intrusive, their about face suggests only that they believe the FCC will now support them in their efforts to undermine local competition.

It has now been eight months since the final hearing in the Virginia Arbitration and two years since the Arbitration was first filed at the FCC. Under the Act, a state commission only has nine months to resolve arbitration issues from the date on which the ILEC receives an interconnection request.[7] The Bureau should expeditiously resolve the pricing issues in the Virginia Arbitration based on the extensive evidence before it. That evidence, as well as basic TELRIC principles, shows the fallacy of the arguments SBC and Verizon make in their letters.

I. Depreciation

SBC urges the Commission to direct the states to use "accurate and reasonable economic depreciation lives used for financial reporting purposes" for the purposes of setting TELRIC prices rather than the "historical, backward-looking legacy regulation depreciation rates" most states have adopted.[8] Verizon requests identical action. Both BOCs thus ask the Commission to ignore the extensive record from the Virginia arbitration showing why this would be inappropriate, and the overwhelming number of state commissions that have rejected this argument.[9]

The FCC itself has already rejected the BOC argument for financial lives, when it endorsed the use of regulatory lives in the TELRIC model used in the universal service proceeding.[10] The reasons articulated by the Commission at that time still hold. Regulatory depreciation lives already reflect expected technological change and obsolescence, not just the engineered life of the plant. In addition, financial lives are set conservatively short in order to protect investors. As such, the Commission noted, the financial lives would not reflect economic depreciation.

In fact, the flexibility with regard to regulatory lives granted to the incumbent local exchange companies (ILECs) further ensures that these lives are not uneconomically long. Under the Commission's original depreciation method, equipment lives had been set for each company in three-way meetings among the company, the Commission, and

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[7] See 47 U.S.C. § 252(4)(C).

[8] See September 9 ex parte at 3.

[9] See AT&T-WCOM Arb. Exh. 3 (Lee Dir.); AT&T WCOM Arb. Exh. 9 (Lee Reb.); AT&T-WCOM Arb. Exh. 22 (Lee Surreb.).

[10] See Federal-State Joint Board on Universal Service, 14 F.C.C.R. 20156, ¶¶ 426-429 (1999) ("Universal Service Order"). See also In re 1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers, 15 F.C.C.R. 242, ¶ 48 (1999); In re Simplication of the Depreciation Prescription Process, 8 F.C.C.R. 8052, ¶ 46 (1993); Shalala v. Guernsey Mem. Hosp., 514 U.S. 87, 99-100 (1995). The Commission's TELRIC rules say nothing about regulatory lives, requiring only the use of "economic depreciation rates." See C.F.R. § 51.505(b)(3).

state regulators, based on information regarding actual and planned retirements. The Commission has now granted the ILECs greater flexibility in setting their depreciation lives by allowing each company to select lives that are within the range of lives that were allowed in the most recent three-way meetings. As would be expected, the ILECs have selected lives that were at the short end of the range, i.e., they selected the lives that maximized their depreciation expense. These regulatory lives therefore provide a conservatively short estimate of the economic lives of the ILECs' plant.

In most if not all state TELRIC proceedings, the ILECs have advocated use of financial lives, and in most cases have lost. Verizon and SBC are now attempting to have the Commission adopt as the maximum depreciation lives the minimum lives that any party has ever advocated, and that only a very few states have adopted. The evidence in the Arbitration shows that the Bureau should not adopt those lives in Virginia. And there is no basis for using the Arbitration, or any proceeding that is currently pending before the Commission, to direct other states to adopt those lives. It is not the Commission's job to protect the ILECs from state efforts to open their local markets to competition.

II. Cost of Capital

SBC claims that the increased risks it faces as a result of new entry in local telecommunications markets justify a higher cost of capital, and asks the Commission to direct the states to take into account this higher risk in selecting a cost of capital for setting TELRIC prices. Similarly, Verizon argues that the cost of capital should reflect both competitive risk and the risks associated with the regulatory regime to which the firm is subject. However, the Commission's rule already requires that the states use the "forward-looking cost of capital," which will incorporate the risk the ILECs face. <u>See</u> 47 C.F.R. § 51.505(b)(2). Under that rule, Verizon and SBC are able to make the arguments they make here, that they face risks that require a high cost of capital. They can then have those arguments judged based on the facts. Indeed, Verizon made just such arguments during the Virginia Arbitration. The BOCs' real complaint is that they have failed to establish that they operate the kind of speculative endeavor that warrants the sky-high capital costs they seek.

Verizon further argues that the 11.25 percent interstate authorized rate of return (ROR) reflects only the risks the carriers faced in the absence of competition, and must be adjusted upward for use in TELRIC pricing. SBC also asserts the authorized ROR is too low. But the Commission's rules do not direct the states to use the 11.25 percent ROR. The states have based the cost of capital on the record evidence before them. SBC and Verizon present no evidence that the states have not considered the risk that the ILECs face. In fact, in every state proceeding, the states have examined competing cost of capital claims from all parties, and selected costs of capital that incorporate the risks the ILECs face. Simply because the states have not selected the cost of capital that the ILECs want is no evidence that the states have been ignoring the ILECs' evidence on the risks they face. The states simply disagree with the ILECs.

The fact that many states have selected costs of capital that are below the federally authorized 11.25 percent ROR does not show that states have set rates that are too low. That ROR was set back in 1990, when interest rates and costs of capital were substantially higher than they are today.[11] Indeed, WorldCom and other parties have presented studies several times since 1991, using the methodology the Commission used to set the 11.25 percent, all of which showed that the cost of capital has fallen substantially. These studies were based on the capital market's perception of the risk that the Bell companies face under current conditions. Verizon and other parties have presented contrary evidence, but only by employing methodologies rejected by the Commission when it set the 11.25 percent ROR. That the states are finding a cost of capital lower than 11.25 percent is hardly surprising, and no justification for the claim that the states are ignoring the alleged heightened risk that the ILECs face.

Finally, Verizon urges the Commission to adopt as the cost of capital for TELRIC purposes the cost of capital that "the principal proponents of TELRIC" – presumably the competitive local exchange carriers (CLECs) - use when making their own business decisions. Quite apart from the practical problems with such a proposal – determining who are the principal proponents, what costs of capital they use, and which cost of capital should be used if the rates of differ, to name a few – it is unclear why such a cost of capital is relevant. The CLECs' cost of capital is very different from the ILECs' because they face much more substantial risk of failure or unprofitability. TELRIC assumes that the incumbent carriers are wholesalers of telephone facilities to competitors who will compete with them for retail customers. The claim that this assumption means that it is highly risky for the incumbent carrier to provide wholesale facilities or that a wholesaler faces the same risks as a CLEC is entirely without merit.

Indeed, during the Virginia Arbitration, both sides presented extensive evidence on the cost of capital, including evidence regarding the risks faced by Verizon.[12] That evidence included testimony that the internal cost of capital estimate used by a different BOC – Ameritech – was significantly below 11.25 percent.[13] The evidence also showed that the difference in the cost of capital proposed by Verizon and that proposed by AT&T and WorldCom was not primarily related to different assessments of risk at all, and thus that factor should have little influence on the result of the arbitration.[14]

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[11] Furthermore, even at that time the Bell companies presented evidence on competition, which was factored into the Commission's decisions.

[12] <u>See</u> AT&T-WCOM Arb. Exh. 5 (Hirshleifer Dir.); AT&T-WCOM Arb. Exh. 10 (Hirshleifer Reb.); AT&T-WCOM Arb. Exh. 17 (Hirshleifer Surreb.).

[13] <u>See</u> AT&T-WCOM Arb. Exh. 17 (Hirshleifer Surreb.) at 73-74.

[14] Rather it was based on the erroneous assumption of Verizon's witness that the above-average growth rates of the companies in his comparison group, which were nearly <u>double</u> the long term rate of corporate growth – would continue <u>forever.</u> AT&T and WorldCom showed this was impossible. <u>Compare</u> Verizon Arb. Exh. 112 (Vander Weide Dir.) at Attachment 7; 12 Tr. 3427-29 (Vander Weide) <u>with</u> AT&T-WCOM Arb. Exh. 10 (Hirshleifer Reb.) at pp. 10-17; AT&T-WCOM Arb. Exh. 17 (Hirshleifer Surreb.) at 2-6, 12-15.

Now, SBC and Verizon suggest the Commission should adopt a high cost of capital in the Virginia Arbitration based on new evidence of the risk the BOCs claim they are facing. But if SBC and Verizon believes their risk has increased, the remedy is clear. They should attempt to demonstrate the existence of such a risk in state proceedings in their regions, not request a particular result in the Virginia Arbitration without any assessment of the evidence submitted in that proceeding.

III. Fill Factors

Claiming that the ILECs have had the incentives under price cap regulation to reduce their costs, SBC requests that the Commission specify that today's actual fill rates should be used as TELRIC inputs. Verizon makes a similar request. Once again, SBC and Verizon raise in abbreviated form an argument that AT&T and WorldCom refuted definitively with extensive evidence in the Virginia Arbitration.

WorldCom and AT&T showed that even if ILECs have acted efficiently in determining the appropriate fill in their networks, those fill rates would not be an accurate basis for establishing pricing. Spare capacity in today's networks in part reflects capacity the ILECs determined was needed to account for future growth in their networks. But the ILECs cannot charge current CLEC customers to support capacity that will be used by future customers unless the ILEC spreads the costs over future demand as well as present demand.[15] Because ILEC cost models generally model only present levels of demand, the ILECs cannot rely on their current fill factors. They must include in their model only the plant needed to serve present demand with sufficient spare to account for maintenance needs, breakage and short term, but not long term, growth. As the Commission has previously explained, "If we were to calculate the cost of a network that would serve all potential customers, it would not be consistent to calculate the cost per line by using current [customer] demand. In other words, it would not be consistent to estimate the cost per line by dividing the total cost of serving all potential customers by the number of lines currently served."[16]

In addition, even if the ILECs acted efficiently in establishing fill factors for their networks in the past, that does not mean that an efficient new entrant would establish the same fill factors today. Indeed, Verizon argues that demand for ILEC lines is currently decreasing, resulting in lower fill factors in ILEC networks over time. But this means that today's fill factors are not those that even the ILECs would establish for their plant today, but rather these fill factors result in part from demand changes for which the ILECs did not plan. An efficient provider today would take account of the decreasing demand and would not build as much spare plant as the ILECs have done. A new

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[15] See AT&T-WCOM Arb. Exh. 11P (Murray Reb.) at 32-33; AT&T-WCOM Exh. 12P (AT&T/WorldCom Recurring Cost Panel Reb.) at 45-46; AT&T-WCOM Arb. Exh. 20 (Murray Surreb.) at 39-40; AT&T-WCOM Arb. Exh. 14P (Pitkin Surreb.) at 16-17.

[16] See Universal Service Order ¶ 58. See also AT&T Exh. 100 (A. Kahn, The Economics of Regulation) at 121.

provider using current technology would also create a network with less defective plant than typically exists in the ILECs' plant.[17]

Moreover, SBC's assertion that ILECs have always acted efficiently in establishing levels of fill is erroneous even if efficiency were assessed at the time that current plant was put in place. First, price caps covers all large ILECs' interstate rates, but not all their state rates. Thus, it is unclear how strong the efficiency incentives on the ILECs have been. AT&T and WorldCom showed, for example, that in many instances Verizon had failed to live up to the requirements of its own engineering guidelines with respect to efficient fill factors.[18] Second, the ILECs have installed plant for strategic business reasons that may have led to low fill factors, e.g., the ILECs deployed additional loop plant to provide Centrex service for which demand never materialized.

Finally, SBC claims that some states have selected fill factors to achieve lower UNE rates. SBC cites the Wisconsin Public Service Commission's (WI PSC) selection of a 70 percent distribution fill factor as an example, claiming that this fill was selected "solely on the basis that Ameritech's proposed fill factors would cause an unreasonable increase in cost."[19] This is a complete mischaracterization of the WI PSC's decision. The WI PSC noted that Ameritech had asserted in the record that (1) the higher distribution fill factors did cover its costs, and (2) adding additional spare capacity should have little effect on costs. Despite the minor effect that adding spare capacity was acknowledged by Ameritech to have, Ameritech's cost model showed a large increase in costs when the fill factors were increased. The WI PSC objected to the large increase in cost in the model when Ameritech had acknowledged that the increase in reality would be small.

Of course, WorldCom agrees with SBC that a state commission should set UNE rates based on a proper TELRIC methodology – not based on fear mongering concerning the purported impact of the rates produced by that methodology. But that is exactly what SBC is asking for here – requesting a particular result in the Virginia Arbitration not based on the evidence in that proceeding but based on an investor report purporting to show the impact of UNE rates on the BOCs.

IV. Network Evolution

Another "clarification" that Verizon and SBC seek is adoption of their view that TELRIC does not require the instantaneous replacement of the entire network. They urge the Commission to clarify that even efficient companies do not replace their networks overnight.

This claim too was thoroughly aired in the Virginia Arbitration. The BOCs no doubt raise it here because they understand how much that case completely undermined their

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[17] See AT&T/WorldCom Arb. Exh. 12 (AT&T/WorldCom Recurring Cost Panel Reb.) at 47, 63; Tr. 3893 (Riolo); AT&T Ex. 117 (GTE Planning Guidelines) at 17.

[18] See, e.g., AT&T/WCOM Exh. 12P (AT&T/WorldCom Recurring Cost Panel Reb.) at 57.

[19] See September 9 ex parte, Attachment A at 8.

claim. TELRIC does not assume that networks are actually instantaneously replaced every time any new technology comes along. It assumes only that the price that will prevail in a competitive market is determined by the costs of the competitor with the most efficient operations. As Commission Staff noted in an exasperated question to Verizon, TELRIC is not based on the assumption "that you have to pull out" the network every three years, but is a "hypothetical" construct designed to value the existing network in a way that simulates how changes in technology and market conditions cause the revaluation of existing assets in competitive markets."[20] For example, if a new airplane were developed that needed half the staff and got twice the gas mileage, and thus could be operated at half the cost of existing airplanes, the price for flights would be cut in half. Existing airlines might continue to operate the old airplanes, but the price they could receive in the market would no longer reflect their now higher cost structure. Verizon is simply incorrect in asserting to the contrary – at least if one assumes that the market in question is a competitive one.

Verizon claims that the Commission has already accepted the principle that a TELRIC model does not assume instantaneous replacement of all inputs in its decisions regarding a combination of new and growth switch discounts. But the decisions cited by Verizon were section 271 evaluations, where the Commission found only that state decisions fell within a broad range of reasonable rates. Moreover, the switch discount issue concerns a price for an input in a TELRIC model, and does not reflect any judgment about how frequently network components are replaced. When the Commission made its own decision on this issue in the context of the universal service proceeding, it determined to use only new switch discounts.

A proper understanding of TELRIC requires establishment of switching rates based on new switch discounts alone. Indeed, Verizon witness William Taylor testified before the Delaware Public Service Commission that the long-run requirement of TELRIC "says rip every switch out. All of them . . . Leave the . . . wire center locations where they are. And build the network that you would build today to serve the demand."[21] As AT&T/WCOM witness Terry Murray explained during the arbitration, the use of the new switch (and its associated new switch discount) sized for its reasonably foreseeable demand over its economic life places an upper bound on the forward-looking economic cost of the switch. "Growing" a switch incrementally to serve future demand is a rational choice if and only if that option is less expensive on an expected net present value basis than purchasing sufficient capacity up front to meet the total expected demand over the life of the switch.[22] Ms. Murray's testimony was a small part of the extensive testimony that AT&T and WorldCom presented during the Arbitration justifying use of the new switch discount alone that Verizon and SBC now ask the Commission to ignore.[23]

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[20] Tr. 3172.

[21] See AT&T-WCOM Arb. Exh. 11P (Murray Reb.) at 7-10.

[22] See AT&T-WCOM Arb. Exh. 11 (Murray Reb.) at 35 n.46.

[23] See, e.g., AT&T-WCOM Arb. Exh. 24P (Pitts Supp. Surreb.) at 5; Tr. 5145 (Pitts); Tr. 5422-23 (Murray). Verizon makes its argument regarding a mix of new and growth switch discounts while neglecting to mention that the model that it presented during the arbitration relied almost entirely on the

The other example cited by SBC for the proposition that real world companies replace their networks over time concerns the question of whether 100 percent integrated digital loop carrier (IDLC) should be assumed in a TELRIC model for fiber-fed loops.[24] SBC does not dispute that IDLC is the forward-looking technology, but merely argues that no network will reflect only the newest technology. In this case also, SBC misunderstands what costs are relevant for setting prices in a competitive market. Any individual company's cost structure does not establish the price; the price will be determined by the cost structure of the most efficient firm. If that cost structure reflects 100 percent IDLC, as WorldCom believes it does, then that is the technology that should be reflected in TELRIC.[25]

Unlike SBC, Verizon claims that IDLC is not a forward-looking technology that is currently available for all loops. That is an empirical question that is exactly the sort that should be resolved by a state commission and about which extensive evidence was presented in the Virginia Arbitration.[26]

V. Non-Recurring Costs

SBC and Verizon both ask the Commission to "clarify" that non-recurring charges for UNEs should be based on the activity actually required to provision the UNE, seemingly the activity required in the ILECs' existing networks. In essence, the BOCs ask the Commission to apply TELRIC only to recurring charges, not to non-recurring charges, and to use the embedded costs in setting the latter charges. This would be a radical departure from the Commission's existing pricing rules, and the BOCs provide no justification for it.

As AT&T and WorldCom demonstrated at length in response to Verizon's similar request during the Virginia arbitration, efficiencies associated with non-recurring activities have the same effect on the economic value of the ILEC's plant as do efficiencies associated with recurring activities. Thus, there is no justification for setting non-recurring rates on a different basis than recurring rates. In addition, if ILECs were permitted to fully recover from CLECs whatever non-recurring costs they presently incur

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growth discount rather than the new discount. Verizon's cost study, in essence, assumed that an efficient carrier would repurchase its entire inventory of switches at the outset of the study period, but would obtain <u>only</u> the shallow discounts available for growth equipment. This is plainly incorrect. <u>See</u> AT&T-WCOM Arb. Exh. 12P (AT&T/WorldCom Recurring Cost Panel Reb.) at 97-104, AT&T-WCOM Arb. Exh. 11P (Murray Reb.) at 33-35.

[24] For customers who are more efficiently served on loops that have copper feeder as well as copper distribution, IDLC would not be assumed in a TELRIC model.

[25] SBC has at times argued against TELRIC by claiming that once it deploys loops using Project Pronto architecture, a TELRIC model will automatically price loops based on a Project Pronto architecture. But a Project Pronto architecture is only presumed in a TELRIC model if that is the most efficient architecture, and this has nothing to do with what SBC has or has not deployed.

[26] AT&T Ex. 122 (Telcordia Notes on the Networks, Oct. 2000) at 12-52; WorldCom Ex. 116 at 5; WorldCom Ex. 117 at 8-10; WorldCom Ex. 119 at 1-2, 15-16; WorldCom Ex. 120 at 12; Tr. at 4611-17 (Riolo, Gansert); AT&T/WCOM Exh. 12P (AT&T/WorldCom Recurring Cost Panel Reb.) at 29-30.

in serving CLECs, the ILECs would have no incentive to deploy technology designed to reduce those non-recurring costs.

We further showed that recurring and non-recurring rates must be set using the same model. If a technology determined to be most efficient is modeled in determining recurring but not non-recurring rates, both rate determinations will be distorted. A new technology may be more efficient (less costly) than an existing technology because the non-recurring costs associated with the new technology are substantially lower than those associated with the existing technology, even though the recurring costs associated with the new technology are somewhat higher than those associated with the existing technology. In that event, setting recurring charges based on the new technology and non-recurring charges based on the existing technology would result in higher total costs than would exist for either the new technology or the existing technology.[27] For example, the CLEC might have to pay recurring rates that include costs for development of automated OSS, but then pay non-recurring rates based on existing manual processing.

Non-recurring UNE prices should reflect the activities required to provision UNEs on the forward-looking network that is used to set recurring UNE rates. This will ensure that both recurring and non-recurring UNE rates meet the forward-looking, most efficient network standard of TELRIC.

VI. The Meaning of Long Run

Verizon asks the Commission to modify its TELRIC rules to set UNE rates based on what its network is likely to look like in three to five years – in other words, how Verizon's embedded network is likely to evolve over the next three to five years given the technology it already has in place. Thus, even if an efficient carrier constructing a network today would use a particular technology, Verizon claims that technology should not be used in a TELRIC model if, because of the constraints imposed by its existing network, Verizon itself would not adopt that technology in the next 3 to 5 years. This argument too was thoroughly discredited in the Virginia arbitration record, and it is not improved in its summary recitation here.

Verizon's proposal would have the effect of redefining the "long run" out of TELRIC. TELRIC is at its most basic level predicated on the judgment that the actual cost of telephone facilities can best be calculated from the ground up, by relying on the universally accepted economic assumption that prices in real competitive markets are based on long-run forward-looking costs. In the Local Competition Order, the Commission defined "long run" to be a "period long enough so that all of a firm's costs become variable or avoidable," and cited William Baumol's definition in Economic Theory and Operations Analysis, to the effect that the long run "is a period so long that all of a firm's present contracts will have run out, its present plant and equipment will

[27] See, e.g., AT&T/WCOM Arb. Exh. 11P (Murray Reb.) at 41-49.

have been worn out or rendered obsolete and will therefore need replacement."[28] By pricing UNEs based on the long run, the Commission's rules ensure that the UNE prices reflect all the efficiencies that are available. But Verizon's proposal replaces the long run with a period of 3 to 5 years. The Commission has already introduced one source of inefficiency into TELRIC pricing by mandating the use of the current switch locations in the forward-looking network. Allowing other network components to remain fixed would further dilute the efficiencies that should be reflected in UNE pricing.

Moreover, the Commission already has rejected Verizon's proposed approach. In the Local Competition Order, the Commission explained that its adoption of the rule's efficiency assumption, and its rejection of embedded cost as a basis for costing, meant that it was rejecting the standard proposed by Verizon and its fellow incumbents, who through their trade organization had proposed that a TELRIC model should "measure the forward-looking economic costs of existing networks, not the costs of fictitious networks."[29] The Commission concluded that such a model was essentially an embedded cost proposal and would likely yield less accurate and overstated cost results that would frustrate competitive entry.[30] But Verizon continues to attempt to resuscitate its original proposal or something akin to it. Yet in its brief to the Supreme Court, Verizon implicitly acknowledged that this proposal was inconsistent with TELRIC, explaining that "TELRIC necessarily ignores the reality that the incumbent has an existing network whose future capital costs and operating expenses are in large part dictated by the network's current configuration."[31]

In its letter, Verizon at least recognizes that it is here asking for a modification rather than a clarification of TELRIC rules. During the Virginia Arbitration, however, Verizon argued for a three-year planning period without acknowledging that this was inconsistent with TELRIC. Verizon's belated acknowledgment that a three year planning period is not consistent with TELRIC rules provides one further reason why the model Verizon proposed in the Virginia Arbitration should be rejected.

VI. Conclusion

SBC and Verizon have asked the Commission to provide guidance about several inputs used in the cost models that are used to set UNE rates. In every case, the guidance the BOCs would have the Commission give misunderstands TELRIC. In its review of section 271 applications, the Commission has consistently deferred to the states regarding

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[28] Local Competition Order ¶ 677 & n.1682 (quoting Baumol). As Baumol went on to say in the quoted text, "the long run is a period of sufficient duration for the company to become completely free in its decisions from its present policies, possessions and commitments." William Baumol, Economic Theory and Operations Analysis, 290 (4th ed.) 1977.

[29] Local Competition Order ¶ 684 (quoting USTA Reply Brief at 19).

[30] Id.

[31] Brief of Respondents BellSouth, SBC, Verizon and USTA, WorldCom, Inc. v. Verizon Communications, Inc., No. 00-555 (U.S. filed June 8, 2001).

inputs used in the cost models. The Commission should not reverse this course based on the erroneous assertions made here by Verizon and SBC.

Nor should the Commission reach a different result when acting in the stead of the Virginia Commission in setting Virginia rates. WorldCom has no right to expect that the rates adopted in the Virginia arbitration will exactly mirror those it has proposed. But we do have the right to have the Commission review the conflicting evidence, make judgments based on its understanding of TELRIC, and adopt rates based on that evidence and those judgments without regard to compromise calculations, an unprincipled desire to allow the BOCs to recover what they claim to be their embedded costs, or post-hearing letters pleading points definitively disproved in the Arbitration itself.

Verizon has had its chance to make its case. The Commission should set rates in Virginia promptly and disregard these ill-advised special pleadings.

Please call me with any questions about this matter.

Sincerely,

/s Chris Frentrup
Senior Economist
WorldCom, Inc.

cc: Chairman Powell
Commissioner Abernathy
Commissioner Copps
Commissioner Martin
William Maher – Chief Wireline Competition Bureau
J. Miller
T. Navin
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